



**STATE BOARD OF EQUALIZATION  
STAFF LEGISLATIVE BILL ANALYSIS**

DRAFT

Date Amended:	<b>05/05/09</b>	Bill No:	<a href="#"><b>AB 1523</b></a>
Tax:	<b>Sales and Use</b>	Author:	<b>Calderon</b>
Related Bills:		Position:	<b>Support</b>

**BILL SUMMARY**

This bill would exempt from the one percent statewide sales and use tax increase operative April 1, 2009 fixed price contracts entered into prior to the rate increase, as specified. The bill would also incorporate a permanent exemption for fixed price contracts entered into prior to a rate increase, as specified.

**SUMMARY OF AMENDMENTS**

The amendments to this bill since our last analysis incorporate an exemption for fixed price contracts during the period of any future rate increase.

**ANALYSIS**

**CURRENT LAW**

Existing law imposes a sales or use tax on the sale or purchase of tangible personal property in this state, unless specifically exempted.

As of April 1, 2009, the statewide sales and use tax rate (8.25%) will be imposed on taxable sales and purchases of tangible personal property, and is made up of the following components (additional district taxes are levied among various local jurisdictions and are not reflected in this chart):

Rate	Jurisdiction	R & T Code
4.75% 0.25% <u>1.00%</u> 6.00%	State (General Fund)	6051, 6201, 6051.3, 6201.3 6051.7, 6201.7
0.25%	State (Fiscal Recovery Fund)	6051.5, 6201.5
0.50%	Local Revenue Fund	6051.2, 6201.2
0.50%	Local Public Safety Fund	§35 Art XIII St. Constitution
1.00%	Local (0.25% County transportation funds 0.75% City and county operations)	7203.1

---

*This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position.*

**PROPOSED LAW**

This bill would add Section 6376.3 to the Revenue and Taxation Code to provide that during the period of the 1% sales and use tax rate increase, sales and purchases of the following are exempt from the 1% increase:

- Tangible personal property, if the seller is obligated to furnish or the purchaser is obligated to purchase the property for a fixed price pursuant to a contract entered into prior to the operative date of the increase.
- Materials and fixtures obligated pursuant to an engineering construction contract or a building construction contract entered into for a fixed price prior to the operative date of the rate increase.
- A lease of tangible personal property that is a continuing sale of the property for any period of time for which the lessor is obligated to lease the property for an amount fixed by the lease prior to the operative date of the rate increase.
- The possession of, or the exercise of, any right or power over tangible personal property pursuant to a lease that is a continuing purchase of the property for any period of time for which the lessee is obligated to lease the property for an amount fixed by a lease entered into prior to the operative date of the rate increase.

The bill would specify that (1) tangible personal property, (2) the sale or lease of tangible personal property, and (3) the storage, use, or other consumption of, or possession of, or exercise of any right or power over, tangible personal property, shall not be deemed obligated pursuant to a contract or lease for any period of time for which any party to the contract or lease has the right to terminate the contract or lease upon notice, whether or not the right is exercised.

The bill would also add Section 6376.4 to incorporate a similar exemption during the period of an increase in the sales and use tax rate on and after January 1, 2010.

The bill would become effective immediately upon enactment.

**BACKGROUND**

AB 3xxx (Ch. 18, Stats. 2009, Third Extraordinary Session), a special session measure to deal with the state's fiscal crisis, was signed into law on February 20, 2009. Among other things, that measure increased the State's General Fund sales and use tax rate by 1%.

In the past, legislation enacting sales and use tax increases has historically contained provisions that exempt fixed price contracts from the rate increase – provisions that are substantially the same as the language in this bill. For example, California's last state sales and use tax increase occurred in July 1991 with the enactment of AB 2181 (Ch. 85, Stats. 1991) and SB 179 (Ch. 88, Stats. 1991). The rate was increased by 1.25 percent in response to the budget shortfall and the exemption for fixed price contracts entered into prior to the operative date of the increase was part of that enactment.

Prior to that increase, for a 13-month period beginning December 1, 1989 and ending December 31, 1990, a 0.25 percent state sales and use tax increase was enacted in response to the October 17, 1989 earthquake (commonly referred to as the Loma Prieta earthquake) in the San Francisco Bay Area (SB 33x, Ch. 14, Stats. 1990, First

Extraordinary Session). That measure also contained an exemption for fixed price contracts entered into prior to the date of the rate increase.

A general fixed price contract exemption is also contained in the Transactions and Use Tax Law (and has been since 1979) for purposes of exempting all fixed price contracts from the various city and county tax rate increases when those contracts are entered into prior to the operative date of those rate increases (see Revenue and Taxation Code Sections 7261(g) and 7262(f)).

## COMMENTS

1. **Sponsor and Purpose.** The sponsor of this bill is the Associated General Contractors of California. Its purpose is to protect contractors with fixed price contracts from bearing the cost of the one percent increase that cannot be passed onto their customers.
2. **The May 5, 2009 amendments** incorporate a new provision in law that would provide a general fixed price contract exemption for purposes of exempting fixed price contracts from future rate increases.
3. **This bill would address an issue of equity.** A fixed price contract exemption is designed to protect the business expectations of the parties when they entered into the contract and protect them from an unplanned increase in tax rate. Under a fixed price contract, the contractor assumes all of the cost variation risk and reward. If the cost exceeds the contract price, the difference comes out of the contractor's pocket. Absent an exemption for fixed price contracts, when the sales and use tax rate increases, for existing contracts entered into prior to April 1, 2009, the contractor will be liable for the increase in the sales and use tax rate on any purchases and sales made pursuant to the contract on or after April 1, 2009. However, due to the nature of a fixed price contract, the contractor may not pass that increase on to the customer or recoup his or her costs in any other manner. Consequently, the contractor alone must bear the out-of-pocket cost of the rate increase. Enactment of this bill would assure that a contractor's liability for sales or use tax in connection with fixed price contracts and fixed price lease agreements entered into prior to April 1, 2009, would be limited to the sales and use tax rate in effect at the time the contractor and his or her customer entered into the contract. This change would also eliminate any issues between a contractor and his or her customer in cases where a contractor inappropriately attempts to collect the additional tax from the customer on a fixed price contract.
4. **When is a contract deemed "fixed price?"** The Board currently administers a similar exemption for fixed price contracts under the Transactions and Use Tax Law, and has administered fixed price contract exemptions on past statewide sales and use tax increases. Therefore, we would apply the same principles to contracts and leases affected by this measure. To qualify as "fixed-price," neither party may have the right to adjust the price for an increase in costs or an increase in taxes, and the amount of the tax or the rate of the tax must be specifically stated in the contract or lease agreement. For example, a contract that says "plus applicable taxes" would not be regarded as a fixed-price contract. In addition, a contract would not be considered a "fixed-price" contract if either party has the unconstitutional right to terminate the contract or lease. If the contract or lease qualifies as fixed-price, the

contractor or lessor would only be required to report and remit the rate in effect at the time the contractor and customer entered into the contract.

5. **For ease of administration, the bill should be enacted before July 1, 2009.** The out-of-pocket expense of the 1% increase for which the majority of retailers, contractors and lessors would be liable is due to the Board on or before July 31, 2009 for those taxable sales or continuing leases made during the months of April, May and June. If this bill is enacted before July 1, a credit for the 1% increase could be claimed by retailers, contractors, or lessors on their quarterly returns. If the bill is enacted later, there is concern with the administrative complexities and costs associated with processing potentially numerous claims for refund.
6. **Technical amendment.** On page 3, lines 37-37, "July 1, 1993" should be replaced with "the operative date of the rate increase."

## COST ESTIMATE

If the bill becomes law before July 1, 2009, some absorbable administrative costs would be incurred in notifying affected taxpayers and revising publications and manuals. However, the later the effective date of the bill, the more administrative costs would increase related to the processing of claims for refund. These costs would be commensurate with the number of claims received.

## REVENUE ESTIMATE

Many contracts are crafted in such a way that they would not qualify as fixed price contracts and would not qualify for this exemption. These contracts often contain protective clauses that ensure that any tax increases will be borne by the customer. The percentage of such contracts is unknown. In addition, we do not know the value of taxable sales for both fixed priced contracts and/or continuous lease agreements that may qualify for the exemption pursuant to this bill.

The revenue loss for exempting these contracts and agreements from the 1% sales and use tax increase could be as low as \$1 million or as high as \$20 million.

The actual revenue loss could be significantly below \$1 million because of protective clauses, or other specifics of a contract, or even significantly higher than \$20 million absent of protective clauses and other specifics of a contract.

Analysis prepared by:	Sheila T. Waters	916-445-6579	05/11/09
Revenue estimate by:	Bill Benson	916-445-0840	
Contact:	Margaret S. Shedd	916-322-2376	
ls			1523-2sw.doc